Department of Community and Economic Development

Economic Development Committee Meeting

March 7, 2005
4:00 p.m.
4th Floor Conference Room 4A
City Hall
777 B Street
Hayward, CA 94541-5007

A G E N D A

Public Comments: (Note: For matters not otherwise listed on the agenda. The Committee welcomes your comments under this section but is prohibited by State Law from discussing items not listed on the agenda. Your item will be taken under consideration and referred to staff.)

1. **Call to Order**

2. **Approval of Minutes (February 7, 2005)**

3. **Economic Development Activities Update for February**

4. **Overview of the East Bay Economy – Bruce Kern, Executive Director, Economic Development Alliance for Business**

5. **Committee Member Announcements**

6. **Adjournment**

Assistance will be provided to those requiring accommodations for disabilities in compliance with the Americans with Disabilities Act of 1990. Please request the accommodation at least 48 hours in advance of the meeting by contacting Katy Ramirez at 510/583-4250 or by calling the TDD line for those with speech and hearing disabilities at 510/247-3340.

ECONOMIC DEVELOPMENT COMMITTEE
REGULAR MEETING MINUTES
FEBRUARY 7, 2005

CALL TO ORDER: Chair Mullins called the meeting to order at 4:11 p.m.

ATTENDANCE:

Committee Member	Present 2/07/05	All Meetings Year to Date		Meetings Mandated By Resolution	
		Present	Absent	Present	Absent
Timothy Barrow	✓	6	1	6	1
Mayor Cooper	✓	7		7	
Council Member Ward	✓	5	2	5	2
Council Member Dowling	✓	7		7	
Ed Mullins (Chair)	✓	7		7	
Joel Peña (Vice Chair)	✓	6	1	6	1
Lisa Ringer	✓	5	2	5	2
Kenneth Gibson	✓	6	1	6	1

OTHERS ATTENDING: Jesús Armas, City Manager
Sylvia Ehrenthal, Director of Community & Economic Development
David Korth, Social Services Planning Manager
Sally Porfido, Economic Development Specialist
David Gilbert, Public Affairs Manager, Joint Genome Institute
Kelly Wallace, Executive Director, Berkeley Biotechnology Education, Inc.

PUBLIC COMMENT: None

APPROVAL OF MINUTES: The minutes of January 10, 2005 were approved.

ECONOMIC DEVELOPMENT ACTIVITIES UPDATE FOR DECEMBER:

Staff met with Josie Sette, Program Manager Contract Education, Ohlone College to learn about a new grant funded program called Biotechnology Education and Training Alliance (BETA). This program provides free training for existing biotech company employees. Ms. Sette is performing a needs assessment with the Hayward biotech companies to see how it may benefit them. This is a two year, $400,000 grant. Ms. Sette invited Sally to attend a BETA meeting to be held in Fremont at Inamed.

On January 28, Sally attended the BETA lunch meeting in Fremont. Other members of this group include Ohlone College's Biotechnology Dept. Faculty, Cities of Newark, Fremont and Union City, EDAB, and 11 Biotech companies including 5 from Hayward. The focus of the

group is to increase biotechnology awareness in the community, assist in the grant funded training, and support and promote the biotechnology industry in the region. Staff will attend future BETA group meeting.

Staff met with Linda Barbaro, Employment & Training Manager of Alameda County Social Services to get an update on their services for displaced and unemployed workers.

Staff provided Linda Barbaro with a copy of the WARN notice from Tree of Life informing of their Feb. 1, 2005 plant closure. Linda followed up with the company and set up a January 20, 2005 Workforce Investment Board training/information meeting with the displaced employees. There are 70 positions being eliminated and she projected a strong turnout for the meeting.

BIOTECH UPDATE:

Ms. Ehrenthal introduced the guest speakers, Mr. David Gilbert, Public Affairs Manager for the Joint Genome Institute, U.S. Department of Energy, and Mr. Kelly Wallace, Berkeley Biotechnology Education, Inc.

Mr. Gilbert explained that the Department of Energy Joint Genome Institute (JGI) was created in 1997 to unite the expertise and resources in genome mapping, DNA sequencing, technology development, and information sciences pioneered at the Department of Energy (DOE) genome centers at Lawrence Berkeley National Laboratory, Lawrence Livermore National Laboratory, and Los Alamos National Laboratory. In 1999 the University of California which manages the three national labs for the DOE leased 60,000 sq. ft. of laboratory and office space in a light industrial park in Walnut Creek, CA to consolidate activities and accommodate JGI's 160 employees in what is known now as the Production Genomics Facility (PFG). The JGI has an annual budget of approximately $60 million funded predominantly by the Office of Biological and Environmental Research in DOE's Office of Science.

The mission of the JGI is to advance new sequencing and other high-throughput, genome-scale and computational technologies as a means for discovering the characterizing the basic principles and relationships underlying the organization, function, and evolution of living systems. Investigations by JGI and its partners are shedding light on the cellular machinery of microbes and how they can be harnessed to clean up contaminated soil or water, capture carbon from the atmosphere and produce potentially important sources of energy such as hydrogen and methane.

In February 2004, the JGI launched the Community Sequencing Program (CSP). The CSP was created to provide the scientific community at large with access to high-throughput sequencing at the JGI. Through this program the DOE has established JGI as a user facility that will advance genomics research in a broad range of disciplines where DNA sequence information is likely to drive scientific discoveries.

Mr. Gilbert also mentioned that their lease will be up in two years and they are looking for a place to relocate that has a stable work force. They expressed interest in Hayward and Sylvia Ehrenthal offered to be their point of contact within the City for a possible relocation.

Mr. Gilbert explained that the Bay Area is the birth place of Biotech. There are currently 85,000

people employed in Bioscience. The average wage paid for workers in Biotech with no degree is $25,000 to $30,000 per year.

At this point, Mr. Gilbert introduced Mr. Kelly Wallace, Executive Director of Berkeley Biotechnology Education, Inc. (BBEI). Founded in 1993, BBEI is a national nonprofit organization that connects youth to the world of biotechnology and coordinates a hands-on, science-based education and job training program for students typically underrepresented in science and technology. Established by Bayer HealthCare as part of a long-term Development Agreement with the City of Berkeley, BBEI has contracted with over 60 industry partners and currently works with two school districts. Since its inception, BBEI has focused on helping youth successfully navigate the world of work, school and life while specifically training them for technical positions in bioscience.

BBEI supports students through a three-year program encompassing the junior and senior years in high school and one year at Laney College. At the completion of the programs students receive a Certificate of Achievement in Biotechnology, which qualifies them for skilled entry-level positions in the biotech field, a growing industry that offers well-paid jobs and real opportunities for career advancement and continued education.

Mr. Armas asked what motivates their biotech partners to be partners in this effort? Mr. Gilman answered that Biotech companies have an interest in developing employees from their own communities. They will invest in 6 months to a year of training because they believe these entry level people will stay with them.

COMMITTEE MEMBER ANNOUNCEMENTS:

None.

ADJOURNMENT: Meeting was adjourned at 5:10 p.m.

East Bay Economic Outlook
January 2005

Created for the
East Bay **E**conomic **D**evelopment **A**lliance for **B**usiness
and the Contra Costa Council

By Christopher Thornberg
Senior Economist
UCLA Anderson Forecast

For new quarterly forecasts and monthly updates, go to www.edab.org

East Bay Fast Stats

All data seasonally adjusted unless otherwise noted

		East Bay MSA			San Francisco MSA			San Jose MSA		
		Level	1 Qr	1 Yr	Level	1 Qr	1 Yr	Level	1 Qr	1 Yr
Household	Labor Force	1,275,600	0.1%	1.0%	910,700	0.7%	1.6%	863,000	-0.6%	-2.3%
04 Q4	Household Jobs	1,212,900	0.4%	2.1%	872,300	1.0%	2.7%	818,300	-0.2%	0.0%
	Unemployment Rate	4.9%	-0.3%	-1.0%	4.2%	-0.2%	-1.0%	5.2%	-0.4%	-2.2%
Payroll	Total Non-Farm	1,028,600	0.4%	1.1%	952,000	0.2%	1.0%	836,300	-0.4%	-1.0%
04 Q4	Construction	72,300	2.3%	6.5%	41,700	-0.5%	-4.4%	37,000	-2.1%	-2.9%
	Manufacturing	96,600	0.0%	0.8%	46,700	0.6%	3.1%	170,500	-0.4%	-0.9%
	Trade	196,200	-0.2%	0.2%	168,100	-0.1%	1.1%	127,700	-0.5%	0.1%
	Information	30,300	-0.3%	-2.9%	45,600	-0.9%	-1.3%	31,400	0.6%	3.0%
	Financial Services	70,100	0.7%	3.4%	92,200	0.7%	2.3%	34,700	-0.3%	-0.6%
	Professional Services	144,100	-0.1%	1.6%	179,100	0.7%	2.2%	158,100	-0.8%	-2.6%
	Education Health	119,600	0.7%	1.4%	100,400	-0.3%	2.3%	93,600	-0.1%	0.4%
	Leisure and Other	120,200	1.4%	1.1%	150,900	-0.4%	1.0%	91,600	-0.1%	-1.3%
	Government	178,200	-0.1%	-0.7%	127,200	1.0%	-0.7%	91,600	0.5%	-1.6%
Hotels	Rooms	14,100	2.2%	3.7%	35,400	1.1%	7.9%	17,400	2.4%	6.7%
04 Q3	Occupancy	56.5%	0.8%	1.9%	66.9%	0.6%	4.8%	57.0%	1.2%	2.7%
Industrial	Rented Space	102,700	0.2%	0.5%	32,200	0.3%	0.6%	37,600	-0.3%	0.3%
04 Q3	Vacancy	10.3%	-0.1%	-0.2%	8.3%	-0.1%	-0.3%	13.0%	0.1%	-0.2%
Office	Rented Space	72,500	0.3%	1.4%	82,900	0.9%	2.9%	58,700	0.7%	1.6%
04 Q3	Vacancy	17.5%	-0.1%	-0.4%	21.8%	-0.6%	-1.9%	23.5%	-0.5%	-0.9%
Retail	Rented Space	98,600	0.4%	1.8%	69,100	0.4%	1.8%	53,500	0.8%	3.5%
04 Q3	Vacancy	6.2%	0.0%	-0.6%	6.5%	-0.3%	-1.1%	13.1%	-0.1%	-2.0%
Permits	Non-Residential ($)	$263,500	0.6%	11.0%	$227,500	-11%	19%	$248,500	15%	2.4%
04 Q3	Single Family	1,600	0.0%	-20%	300	0.0%	0.0%	800	60%	33%
$000	Total Residential	3,200	10.%	0.0%	1,500	36.4%	66%	1,700	89%	13%
	Residential Value	$833,400	11.%	1.6%	$460,200	5.2%	24%	$398,300	37%	16%

Sources

Household and Payroll Employment Data: EDD and UCLA Anderson Forecast

Vacancy Statistics: PPR and UCLA Anderson Forecast

Building Permits: CIRB and UCLA Anderson Forecast

East Bay Fast Stats (cont)

All data seasonally adjusted unless otherwise noted

		04 Q3	1 Qr	1 Yr	
Airport	Oakland Int.	3543100	0.2%	2.8%	
Passengers	SFO	8315400	0.1%	13.9%	
		04 Q3	1 Qr	1 Yr	
Taxable Sales	Alameda	5637500	-0.5%	1.8%	
	Contra Costa	3242000	2.1%	5.2%	
	San Francisco MSA	6749900	-2.0%	-0.8%	
	Santa Clara	7073500	-0.6%	0.2%	
		04 Q4		04 Q4	
		Level	1 Yr	Level	1 Yr
Residential	Alameda	$498,000	17.8%	6,999	4.0%
Real Estate	Contra Costa	$474,000	19.0%	6,690	5.1%
NSA	Marin	$719,667	16.5%	1,225	3.3%
	Napa	$537,333	18.0%	677	21.1%
	San Francisco	$682,000	19.7%	1,849	-13.9%
	San Mateo	$662,667	19.0%	2,561	-2.8%
	Santa Clara	$560,333	14.9%	7,851	-2.7%
	Solano	$405,667	25.6%	2,949	21.4%
	Sonoma	$477,667	19.1%	2,344	-8.4%
		03 Q3	04 Q3		
Exports from California (NSA $Mil)		YTD	YTD		
Total		$67,668	$81,485	20.4%	
Computers and Electrical		$26,297	$31,435	19.5%	
Machinery Except Electrical		$6,782	$9,385	38.4%	
Transport Equipment		$5,986	$8,963	49.7%	
Chemicals		$4,421	$4,877	10.3%	
Misc Manufacturing		$3,604	$4,122	14.4%	
Agricultural Products		$3,252	$3,599	10.7%	
Food and Kindred		$2,934	$3,023	3.0%	
Electrical Equipment		$2,132	$2,531	18.8%	
Fabricated Metal		$1,736	$1,962	13.0%	

Sources

Taxable Sales: Bureau of Equalization and UCLA Anderson Forecast

Residential Real Estate: DataQuick

Exports from California: MISER Trade Database

Overview and Outlook:

The final numbers from 2004 are coming in, and it doesn't look like a bad year for the East Bay and its neighbors under the circumstances. After experiencing one of the worst regional downturns in US history between 2001 and 2003, the region moved back into a growth path in 2004, albeit at a slow pace. The East Bay added 1% to its payroll workforce Q4 to Q4, while San Francisco added slightly more proportionally. San Jose lost another percent even as recovery continues. We don't currently expect a large revision one way or the other next month when the new benchmarks come out. The employment numbers from the household survey are more positive, and unemployment continues to fall to below the national average. Taxable sales are on the rise again for the first time as well, and office, industrial and retail vacancies are all on the decline. However over-building in the late nineties will continue to have a negative impact on the non-residential construction market for years to come.

The troubles being felt in the Bay Area are primarily a result of the continued turmoil related to the healing process from the late nineties bubble. Indeed all numbers point to a resurgent IT industry over the past year, with exports, spending and production in the industry all on the rise, despite the fears of outsourcing and trade. The Bay Area and the East Bay have not yet felt this new surge because of continued excess capacity in the industry that continues to dampen profits and curtail industry growth even though revenues and sales are on the mend. In short, IT remains a size-14 industry trying to fit into a size-10 market.

Some slimming down is still needed and the diet will remain a drag on the area in the short run. The wave of mergers currently occurring, including of course the much discussed PeopleSoft takeover by Oracle, is part of this process. Look for it to continue, with workers continuing to be released. Still, growth and new ventures will likely make the process of finding new employment less painful in 2005 than in previous years. The diet is working, however, and we expect that 2005 will be the year that the region slips in with only a minor amount of sucking in.

Look for decent growth in the East Bay in 2005 with payroll jobs expanding between 1.5% and 2%, with San Francisco not far behind. San Jose, hardest hit and farthest behind, will add .5% to 1%. Taxable sales will increase by 5% for Alameda, slightly more for Contra Costa and slightly less for San Francisco and San Jose. The local recovery, however, will be tempered by at best mediocre growth in the national economy. While Wall Street continues to predict a 4% year, we cannot see anything beyond 2%. Consumer, government and business spending are all at levels that are too high already. At best we can

only expect normal or slow growth.

At the national level only the export industry has enough slack to drive any new surge in growth. Unfortunately, reluctance on the part of China and Japan to allow their currencies to appreciate relative to the dollar -- despite the financial ramifications to their central banks -- will hamper this. If these nations decide to begin dumping US treasury bonds in a hurry, it could have substantial implications for the US economy. Keep an eye out.

The following year, 2006, is cloudier because of the economic storms looming on the national horizon. It's not energy, and it's not commodity prices. These capture a lot of headlines due to their recent surge in price -- but it needs to be remembered that these items have much more elastic supply and demand in the long run. The resurgent world economy surprised many with the sudden rapid increase in demand. Suppliers are catching up though, so look for the prices to begin to come down in 2005.

The true threat to the national economy is the continued expansion of the real estate bubble both in the Bay Area and in the rest of the nation. This has been a continuing positive source of demand growth for almost fourteen years now, and the high rates of investment have clearly saturated the new housing market despite the efforts of the industry to pretend otherwise. One clue to this is the increasingly extreme forms of financing mortgage companies are using to try and cajole even the most marginal buyers out of the woodwork.

As the bubble starts to slow over the course of the next 12 to 18 months, look for residential investment to slow substantially, and the lack of home appreciation being added to home-owners' income statements will have a secondary impact on consumer spending. The result could be another economic downturn as early as 2006 and certainly before the end of the decade. This will damped recovery prospects for the Bay Area, but the downturn will have a much smaller impact on the Bay Area overall. The East Bay with its booming residential markets is most at risk, while San Jose and San Francisco will likely be less impacted.

Remember though, in the long run the Bay Area will continue to have a substantial competitive advantage in the world due to its highly educated workforce and its position as a center of technological advances. This is why I am betting long on the area despite its current woes.

The National Economy: Real Estate Worries

Written by Michael Bazdarich, Senior Economist: UCLA Anderson Forecast

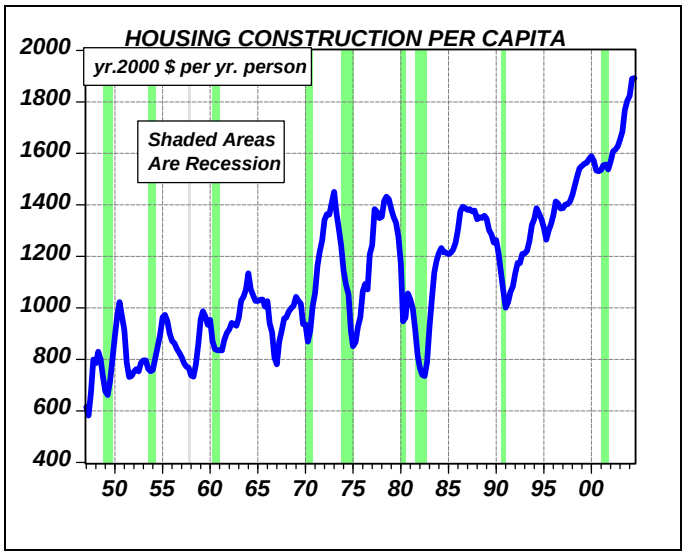
Presently, the Wall Street consensus looks for U.S. economic growth to accelerate to above-trend rates (4% or so) in 2005, led by stronger consumer spending growth, accelerating business investment, good gains in inventory investment and exports, and, apparently, stable or rising levels of housing construction. At the UCLA Anderson Forecast, we expect U.S. growth to decelerate to below-trend rates, down to 2% or even lower in 2005, driven by declining housing construction and a neutral-to-weakening consumer, with no sufficient offset from business investment or exports to offset these restraining effects. The view beyond 2005 is ever murkier, with the potential for substantial reversals in consumer markets to cause yet another economic downturn. In short, while our forecast calls for a weak expansion over the next two years, the downside potential is considerably larger than the upside potential.

Declining Housing. In respect to housing construction, we have professed a concern that home prices have shot up enough across the country—and enough of a speculative atmosphere has emerged—to constitute a housing "bubble." Bubble or no, *U.S. home construction is certainly proceeding at a rate that is much faster than is commensurate with the rate of U.S. household formation*. That is, while U.S. housing starts reached a level of more than 1.9 million units in 2004, U.S. household formation rates were more consistent with construction rates of about 1.5-1.6 million units.

Stimulative declines in mortgages interest rates and tax rates combined with otherwise weak returns in other financial assets have helped stoke housing demand over the last four years, but that stimulus is already fully incorporated in U.S. home demand, and no further stimulus is forthcoming. Meanwhile, with U.S. household formation rates sufficient to sustain only about 1.5-1.6 million units per year, with vacancy rates rising for U.S. rental properties, and with homeownership rates at all-time highs, the U.S. economy is rapidly running out of first-time buyers in numbers sufficient to sustain current housing construction rates. Thus, we are currently forecasting that U.S. housing construction will pull back gradually but steadily to a rate of 1.6 million units per year by the end of 2006. This will exert a substantial drag on U.S. economic growth over the next two years, the antithesis of conditions over 2000-2004, when rising housing construction rates were a constant source of stimulus for the economy.

There is one more factor to consider with respect to housing construction conditions over the next few years. Historically, the national housing market has adhered to market cycles stretching about five years in length, with three-and-one-half to four years of expansion in housing construction followed by one to

one-and-one-half years of contraction (and with housing declines almost always occurring during or preceding recessions). Presently, the U.S. housing market has expanded for fourteen years without any pullback of substance, reflecting the unique nature of the 2001 economic downturn. In past business cycles, of course, an "early expansion" period such as the present would feature strong increases in home construction rates. However, it also was the case in past cycles that such early-expansion gains would come on the heels of severe declines during the preceding recession. Instead, in recent years, U.S. housing construction rose throughout the 1990s, through the recession and soft-growth of 2000-2003, and through the early part of last year. In short, while the current housing market reflects a post-downturn rebound, the problem is that there is nothing to rebound *from*.



Indeed, we think an optimistic projection is for housing construction rates merely to ease back to 1.6 million units per year, as stated above. If mortgage interest rates should rise sharply or the rapid pace of price appreciated began to reverse itself, this "easing back" could become a plunge. As it is, our currently conservative forecast (of an "easing back") looks for home construction to remain reasonably strong—at or above sustainable construction rates—just not "super strong," as it has been over the last three years.

Consumer Spending. Similar to the housing situation, consumer spending has grown continually without a significant pullback ever since the 1990-91 recession. Perhaps more to the point, consumer spending has grown much faster than household incomes ever since 1997, so much so that spending has attained an all-time high share of personal incomes, and personal savings rates have attained yet another all-time low. As was also the case with housing, consumption spending has been boosted in recent years by interest rate and fiscal policy stimuli, but those stimuli have already had their full effect, and no further stimulus is forthcoming.

Here again consumer spending appears incapable of *driving* U.S. economic growth from here on, as it has done in large part for the last four years. Without further stimulus and with household budgets already stretched, consumer spending will do well merely to grow *as fast as* personal incomes. However, this

means that consumers will be at best a neutral factor for the economy, not a *driver*.

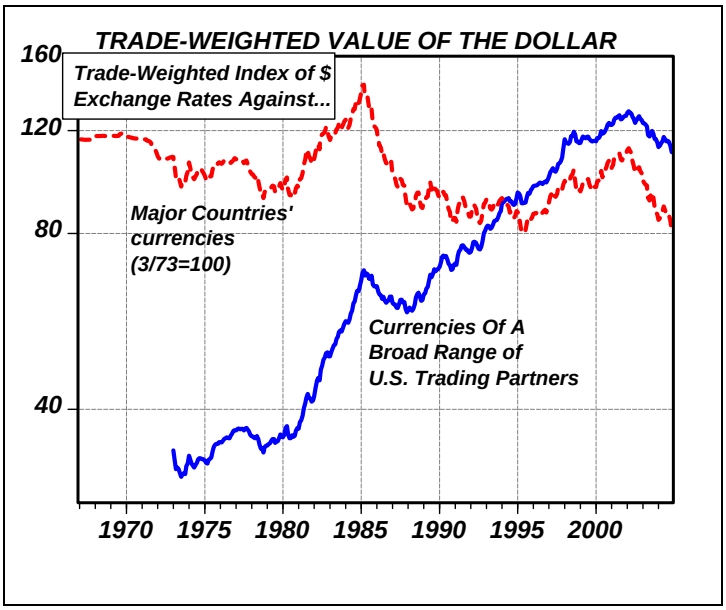
What is more, this is the optimistic forecast. This forecast line assumes no significant attempt by households to work down the historically high debt levels or to build up savings rates from current, stretched positions. As will be discussed below, we do not foresee conditions in the rest of the economy being robust enough to drive more than modest-to-weak growth in GDP and, thus, personal incomes. So, again, the forecast is very optimistic to project that households will, for the time being, continue to labor under heavy debt loads and with low saving rates across a period when the economy continues to under-perform their expectations and hopes.

Other Domestic Demand Components. Meanwhile, government outlays have boosted domestic growth throughout this decade, and rising inventory investment helped in 2002 and again in 2004. Both are at the end of their string. Defense outlays in Iraq are winding down, while anti-terrorism defense outlays are peaking. Meanwhile, state and local outlays are still constrained by deficits, similar to—though not as bad as—those plaguing California. On net, our forecast looks for flat aggregate government purchases in 2005.

Wall Street expects a strong contribution to growth from inventories, because of low inventory-sales ratios among merchants. The fatal flaw in this assertion is that it ignores a steady, secular downtrend in inventory-sales ratios that has been in place for nearly twenty years, thanks to continuing improvements in logistics and inventory control technology. Inventory-sales ratios are low relative to past levels, but they are NOT low relative to prevailing trends. As a result, we would expect only modest rates of inventory investment to allow inventory-sales ratios to drift lower in adherence with prevailing trends. Along such a path, inventories will not provide any boost to aggregate GDP growth in 2005.

Finally, the weaker dollar over the last two years should drive some gains in exports and some import substitution this year, but probably not enough to single-handedly drive robust economic growth. Although extremely strong export growth did drive strong GDP growth in 1987-88 despite accompanying flatness in housing construction, that episode featured 20% growth rates in exports, following a 50% decline in the dollar over 1985-86, on a trade-weighted basis. Presently, the dollar has fallen "only" about 15% since 2002, and the looming presence of extremely low-wage, low-cost import competition from China and India further reduces the chance of a major surge in exports or a major reduction in the domestic market share of imports.

What is more, U.S. exports have been stagnant lately, after a late-2003/early-2004 surge (a good 12% growth rate, but still well below the 20% growth rate of 1987-88). Meanwhile, U.S. imports continue to soar. In 2005 we look for resumed export growth and some slowing in the pace of import growth. However, while this more beneficial foreign trade pattern will provide some boost to the U.S. economy, it will not be enough to drive robust economic growth, opposite less-strong performances in various domestic demand sectors.



The Bottom Line. Add together these various strands, and our models indicate U.S. economic growth of barely 2% in 2005 if, again, there are no major *problems* in housing or consumer spending such as sharper slowing than described above. One of the themes of our forecast line is that economic conditions have not been "normal" for the last decade, making it imprudent to project "normal," robust early-expansion growth presently. It is more likely that the tired consumer and housing sectors will pull back, as will government outlays. Given the prospects for *only* reasonably strong growth in capital spending and exports opposite the other slowing factors, we believe the U.S. economy will do well merely to sustain 2% growth. With the bulk of that growth accruing from business investment and exports, the manufacturing and industrial sectors will perform better than they usually would in a 2%-growth milieu, but that just means that construction will fare worse than usual, and the service sector growth will be slightly below-par for 2% growth conditions.

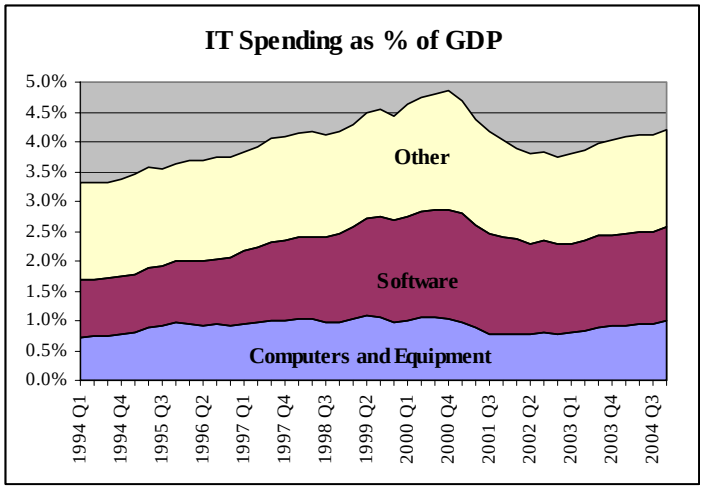
We believe that much of the U.S. productivity "miracle" of recent years is the result of having outsourced lower-productivity, lower-margin jobs abroad, thus raising average productivity since the jobs remaining are higher value-added, higher-margin activities. (Also, the profits earned from outsourcing go right into productivity, as well as into GDP.) The point is that with the market share of imports likely to top out this year, productivity growth is likely to slow down as well. This will allow the U.S. to sustain SOME discernible rate of job growth, say about 100,000 jobs per year (compared to the "jobless recovery" of 2002 and early 2003, when 2% GDP growth was associated with job losses, "thanks" to rapid productivity

growth.) However, that pace will not allow any decline in U.S. unemployment rates.

The Bay Area and the IT Industry

The Bay Area overall has lost a larger percentage of its payroll workforce at a faster pace than any other major metropolitan area since the data have been collected. On the other hand, the Bay region was also experiencing near record growth prior to the downturn, with the major constraint being office space for new employees and places for them to live. In short, a lot of the pain is more a return to a normal growth path than a true shrinking of the economy as Southern California experienced in the early nineties. Last year the region showed the first signs of positive economic outcomes since 2001. On net the area added jobs and 2005 will see even further improvement as discussed below.

Of course the reason for this rapid boom-bust was the IT bubble that drove the economy through the late nineties boom and the early 00's doldrums. Even now the Bay area is still heavily invested in the IT industry -- approximately 12% of the workforce is employed directly in IT related industries, compared to 3.5% for the US overall. This of course doesn't include the many employees who work in secondary industries such as venture capital and industrial service industries linked to the industry, and the booming local service sector. The fortunes of the Bay Area, at least in the short run, still rely heavily on this industry.



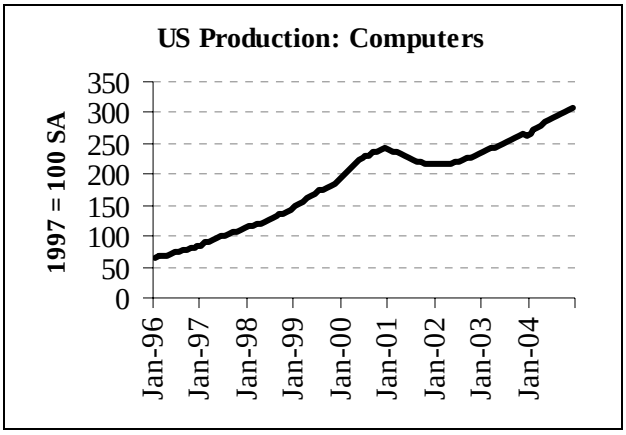
The big question is whether the IT industry will be a driving force of growth in the US economy. Between the stories of outsourcing, waves of mergers and the tough times over the past four years, it is easy to think that the industry might continue to experience economic declines. But instead, the IT industry in the US is showing definite signs of continued expansion, albeit on a more realistic level than experienced during the last boom. And as it continues to grow, the Bay region will follow.

Last year saw business spending continue its recovery from the 2001 downturn even as industrial output

Technology Industry: Year on Year Growth Statistics

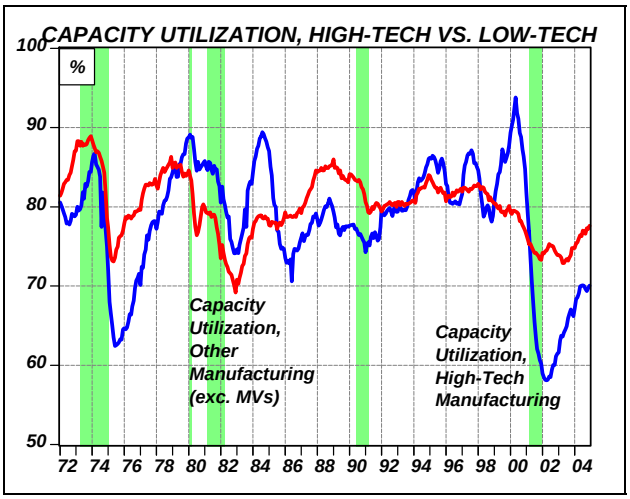
	2002	2003	2004
Shipments Total Manufacturing	-2.6%	2.0%	10.3%
Shipments Computer / Electronic Products	-10.4%	4.1%	12.9%
Semiconductor Billings: Worldwide Market	-12.2%	17.2%	30.6%
Production: Computer and electronic product	-3.6%	12.8%	14.5%
Production: Electrical equipment	-9.1%	-3.3%	5.6%

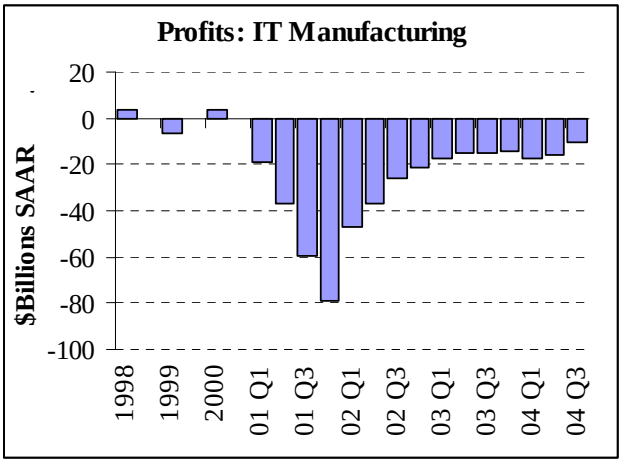
continued to grow. Indeed, while the future of the consumer and residential side of the equation looks grim for the US economy, the business spending side of the economy portrays a reasonably rosier picture. Business spending, particularly on structures and information technology, fueled the go-go economy of the late nineties, and the collapse of the spending bubble drove the 2001 doldrums period. However, it should be kept in mind that while business investment plunged between 2000 and 2002, it went from extremely overdone rates back to merely 'very strong' rates. Spending by businesses directly on Information technology is back above 4.2% of GDP, higher than any point prior to 1999. Worldwide shipments of semiconductors grew by an astonishing 30% in 2004 over 2003.



Of course all this spending would do little good if all the products are simply being imported from overseas. However domestic production of computers and electronic products continue their rapid rates of growth, contrary to the worst stories regarding the supposed ravages of outsourcing. Shipments of computers and electronic products from domestic producers grew 12% in nominal terms in 2004 over 2003, the second year of positive growth. In real terms domestic production is currently 27% above its previous peak at the end of the Internet rush period. And IT continues its evolution inside the US economy. According to preliminary numbers from the Census, Internet sales of goods totaled $17.6 billion in the third quarter of 2004, 2.6% of total non-auto retail sales. This is the highest level yet and reflects the fact that US consumer access to broadband has moved past the 10% mark and continues to grow rapidly as prices come down. California's largest export industry remains computers and electronic equipment. Exports in the first three quarters of 2004 are 20% higher than in 2003, and, at least in nominal terms, are on pace to break the previous record set in 2000.

With all this economic activity in the US IT industry, why doesn't it feel that way on the ground?





Why isn't the Bay Area rebounding on this wave of new prosperity? The reason lies (again) with the rush of the late nineties. Consider the current capacity utilization conditions. Thanks to the massive investment surge in the late-1990s and thanks to the sluggish course of industrial expansion over the last four years, businesses are using only about 75% of their existing productive capacity. In high-tech, capacity has risen to 70% after dropping from above 90% to below 60% in an astonishingly short period of time. Historically, business investment has seen its strongest surges when utilization rates were at 82% or higher. In short, from a historical perspective, the level of investment in the US economy is impressive given the current relatively low level of capacity utilization. For this, we must most likely give thanks to technological advance and obsolescence.

All this excess capacity continues to have an impact on the bottom line and firms in the industry continue to see losses. For example, corporate earnings in IT manufacturing rose to -$10 billion in Q3 2004 (SAAR) despite all the strong demand. This was the best fiscal result since 2000 and considerably better than the $80 billion (SAAR) this sector hemorrhaged in the 4th quarter of 2001. The problem is a size-16 industry trying to fit into a size-10 market.

Indeed the wave of mergers in the industry, including the takeover of PeopleSoft by Oracle, is a reflection of an industry that is experiencing a necessary wave of mergers and consolidation to get back into the black. In short, while demand is strong, supply is still too large. It will take a few more quarters until the industry itself gets back into growth mode so portions of the Bay Area can expect to continue to get disappointing news regarding local firms. But the short-term pain is leading towards a stronger more efficient industry that will become very competitive in the future, and when it does, expect the Bay Area to reap the benefits in a strong recovery.

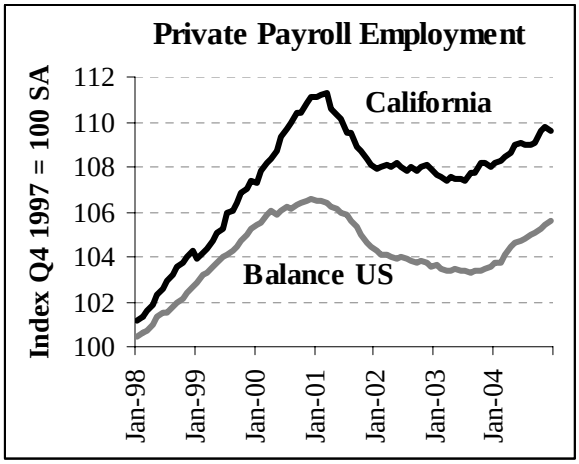
Of course the problem might be solved earlier if there is another surge in business spending on IT technology comparable to the late nineties. This reminds me of my favorite recent bumper sticker, "Please God, Just one more bubble!" Firms will invest rapidly enough to sustain competitiveness and maintain existing, productive capacity. However, current investment levels are already strong enough to accomplish this. No investment surge from the current level is necessary or likely. Indeed capital stock per worker inside the US economy is estimated to be 50% greater than it was not even a decade ago -- testifying to the tremendous change that has occurred inside the US economy as a result of IT advances.

Meanwhile, the recent investment pick-up has ***already*** accomplished nearly as large a contribution to GDP growth as was achieved in the go-go late-1990s. In order to drive accelerated GDP growth -- in fact, in view of declining housing and slowing consumption, in order to even sustain recent GDP growth rates -- business investment growth would have to accelerate from the current level. Given already-high investment rates, given a backlog of unused domestic capacity, and given continued competitive pressures from abroad, a further acceleration in business investment growth is not going to occur this year.

Jobs, jobs, jobs, and that business climate thing

The last quarter of employment statistics are in, and while the results for 2004 are not great, they still reflect a solid improvement over the preceding two years. The State overall added 1% to its total non-farm payroll workforce Q4 2004 over Q4 2003, up from losing .2% Q4 2003 over Q4 2002. The balance of the US added 1.7% to its payroll workforce Q4 to Q4. For those who claim that business climate is playing a role in dampening growth in an economy that typically outperforms the US, this seems like prima-facie evidence.

Unfortunately for these armchair economists even a slight scratching at the surface of this conclusion reveals how tenuous this conclusion is. For example, if we only look at private jobs, the employment growth rates become 1.4% and 1.9% respectively. One quarter of that gap can be explained by the way California's public sector has chosen to handle its fiscal difficulties, rather than how it interacts with the private

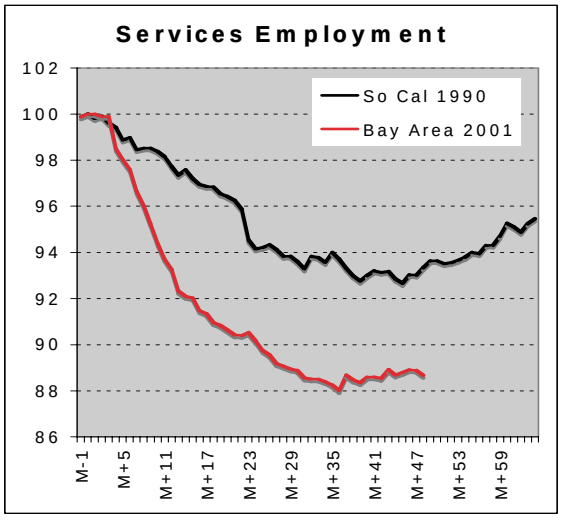


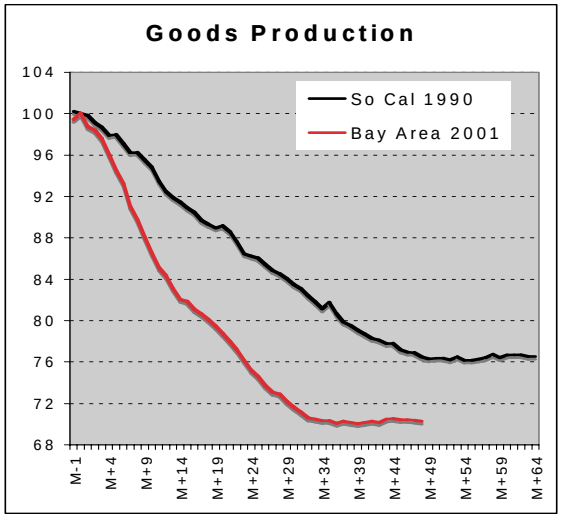
sector. Another factor to consider is that the Bay Area was the worst hit regional economy in the nation during the last downturn -- indeed one of the worst hit regional economies since statistics have been kept. This result can be traced to industry mix and the Bay Region's role as the center of the tech bubble rather than any regulatory issues.

In direct contrast, Southern California as a whole continues to outpace the aggregate US economy and the Inland Empire and San Diego have been among the fastest growing economies in the nation, certainly not consistent with the basic idea of a state paralyzed by high business costs and regulation. Indeed, perhaps a better measure of payroll growth is not to compare current job levels to March of 2001 but to compare job levels in the state to a period prior to the start of the rush. In that comparison, since the 4th quarter of 1997 the state has added 9.4% to its private payroll workforce, compared to 5.5% for the rest of the US.

Of course a long run perspective is hardly helpful during short run bouts of pain. Is the State's regulatory burden inhibiting recovery in the Bay? An economy is an organic system that naturally expands with population and investment despite what often appears to be the best efforts of government to restrict the process. In the absence of anything but the most restrictive controls, the economy will expand to find work for those who desire it in the long run. Such systems can handle small negative shocks fairly easily because a growing economy provides many opportunities for displaced workers and businesses to find alternative opportunities, but takes time to overcome large negative shocks as a result of all the secondary damage to the economy.

The larger the turmoil, the longer it takes for workers to get back on their feet, for businesses to find new





opportunities and for investors to find the confidence to begin investing again. From this perspective the Bay Area was bound to have a tough time for a number of years once the bubble collapsed. Indeed if anything, the Bay Area can be remarked upon for its solid recovery. The following charts compare private employment in the Bay Area in services and goods production relative to what happened in Southern California in the early nineties after the collapse of another important industry in the State -- aerospace. While the region lost more jobs more rapidly than Southern California, recovery has begun earlier and it will likely rebound faster as well.

	Total Non-Farm			Total Private		
	Q4 04	03-04	02-03	Q4 04	03-04	02-03
East Bay	1,028,600	1.1%	-2.3%	853,100	1.4%	-2.1%
San Francisco	952,000	1.0%	-3.6%	828,500	1.3%	-3.5%
San Jose	836,300	-1.0%	-3.9%	748,500	-1.0%	-3.8%
Los Angeles	4,009,200	0.7%	-1.0%	3,435,500	1.1%	-0.7%
Orange County	1,439,900	0.6%	1.2%	1,293,900	0.7%	1.7%
Inland Empire	1,117,200	2.6%	1.4%	923,100	2.6%	2.2%

	Civilian Employment			Unemployment	
	Q4 04	03-04	02-03	Q4 04	Q4 02
East Bay	1,212,900	2.1%	-1.0%	4.9%	6.3%
San Francisco	872,300	2.7%	-1.9%	4.2%	5.9%
San Jose	818,300	0.0%	-2.7%	5.2%	8.7%
Los Angeles	4,557,600	2.8%	-0.8%	6.3%	6.7%
Orange County	1,556,400	1.7%	2.5%	3.1%	4.1%
Inland Empire	1,664,200	3.7%	2.7%	5.3%	6.1%

In part this is due to the fact that many of the secondary collapses in consumer spending and the housing sector that occurred in So-Cal have not occurred in the Bay Area. It also has to do with the fact that information technology is still a growing industry in the US whereas aerospace shrank more or less permanently. Regardless of the reasons, 2004 employment numbers were encouraging. Q4 on Q4 the East Bay added 1.1% to its payroll figures, compared to a loss of 2.3% between 2002 and 2003. San Francisco saw a similar sized expansion, while San Jose saw the loss of jobs slow from 4% to 1% annually. If government jobs are removed from the total, the recovery looks even better. The East Bay added 1.4% to its private payroll workforce. San Francisco accelerated from -3.5% to a positive 1.3%.

Inside these numbers are bad and good news. For the 11,000 East Bay jobs formed in 2004, 6,000 came in the construction and real estate sectors. But these jobs are largely due to the housing boom being experienced in the region, and it is highly likely there will be reversals when the housing markets begin to cool in the next two years. On the other hand the 7,500 new jobs formed in Administrative and Support Services, Healthcare, Professional Services, Durables Manufacturing, Leisure & Hospitality and Finance are jobs that reflect a recovering economy. These gains were offset by a loss of 900 jobs in Information

East Bay Employment by Sector

	East Bay		San Francisco		San Jose	
	Q4 04	03-04 Ch	Q4 04	03-04 Ch	Q4 04	03-04 Ch
Total Non-Farm	1,028,600	1.1%	952,000	1.0%	836,300	-1.1%
Construction	72,300	6.3%	41,700	-4.5%	37,000	-3.1%
Durables Manu	60,000	1.8%	22,600	2.1%	159,200	-0.3%
Non-Durables Manu	36,600	-0.8%	24,100	3.8%	11,300	-9.7%
Wholesale Trade	50,800	0.1%	28,200	2.1%	34,700	2.8%
Retail Trade	108,400	-0.3%	94,800	1.0%	80,000	0.0%
Logistics	37,000	1.5%	45,100	0.5%	13,000	-6.9%
Information	30,300	-3.0%	45,600	-1.1%	31,400	2.8%
Finance Services	50,200	1.4%	69,500	2.0%	20,100	1.4%
Real Estate & Rental	19,900	8.3%	22,700	3.3%	14,600	-3.3%
Professional	67,500	1.6%	99,800	3.4%	94,800	-2.7%
Mgmt Companies	22,900	-1.6%	23,500	-1.9%	14,500	-5.2%
Administration	53,700	2.9%	55,800	1.7%	48,800	-2.0%
Education	18,700	2.0%	23,000	4.8%	27,500	1.8%
Healthcare	100,900	1.1%	77,400	1.6%	66,100	-0.3%
Leisure	81,900	0.9%	113,500	1.5%	68,100	-0.2%
Other Services	38,300	1.6%	37,400	-0.3%	23,500	-4.6%
Government	178,200	-0.7%	127,200	-0.7%	91,600	-1.6%

and 1,300 in Government. In contrast the San Francisco economy -- where many East Bay residents work and whose economic fate is tied closely to East Bay growth -- actually saw the loss of 2,000 construction jobs and 900 public sector jobs. Large gains occurred in Professional Services (3,400), Leisure and Hospitality (1,700), Finance (1,400), Healthcare (1,200) and Education (1,100). Administrative Support, Retail Trade and Non-Durable goods all added 1,000 jobs each. San Jose employment patterns show an economy still trying to get around the bend with continued losses in Professional Services, Construction, Manufacturing, Administrative Support and Logistics. Only Wholesale Trade and Information have shown any serious signs of growth in this region.

More evidence minimizing the argument that business climate is stifling job formation comes from the household survey side of the equation. According to employment numbers drawn from the survey of households, since the 4th quarter of 2000 California has added 3.1% to its total employment, even as payroll jobs *fell* by .5%. According to the household survey, the balance of the US employment only rose 1.9%. These numbers, collected from the monthly unemployment survey, reflect in large part a return to the early nineties when California experienced its first major expansion of the informal, non-payroll employment sector. The rapid growth of payroll jobs in the bubble caused the informal sector to shrink, but more recently the economic downturn has caused the numbers to run back up again.

Currently the informal sector in the State represents about 12% of the payroll workforce. Texas has the

second largest informal workforce in the nation with a body of workers representing 6% of its payroll workforce. Most of these jobs in California are in the greater Los Angeles region, but the trends are the same across the state. They tend to be spread across many sectors of the economy from what can be surmised by comparing the two sets of data. Admittedly some of the jobs certainly represent the legitimately self-employed, but many others represent jobs that probably should be listed as payroll jobs. Here we may find real evidence of a high cost of doing business: the cost to employers encourages businesses to avoid formally hiring employees or under-reporting the true size of their workforce. But of course this has not slowed growth, only pushed it underground. More study is clearly needed, and if recent rumblings from Sacramento are to be believed, more will be forthcoming. Yet it should be cautioned that we are unlikely to find the magic bullet to the state's fiscal problems here, since most of these workers are likely to be low-skilled and low-pay.

Like the state as a whole, household survey employment paints a better picture in the Bay Area than do the payroll figures, growing by 2.1% in the East Bay in 2004 and 2.7% in San Francisco. This largely explains the rapid fall in unemployment. The rate in the East Bay is currently 4.9%, compared to 6.3% two years ago. For San Francisco unemployment is at 4.2% compared to 6% two years ago. Even hard-hit San Jose has seen unemployment fall from 8.7% to 5.2% over the last two years despite the continued loss of payroll jobs.

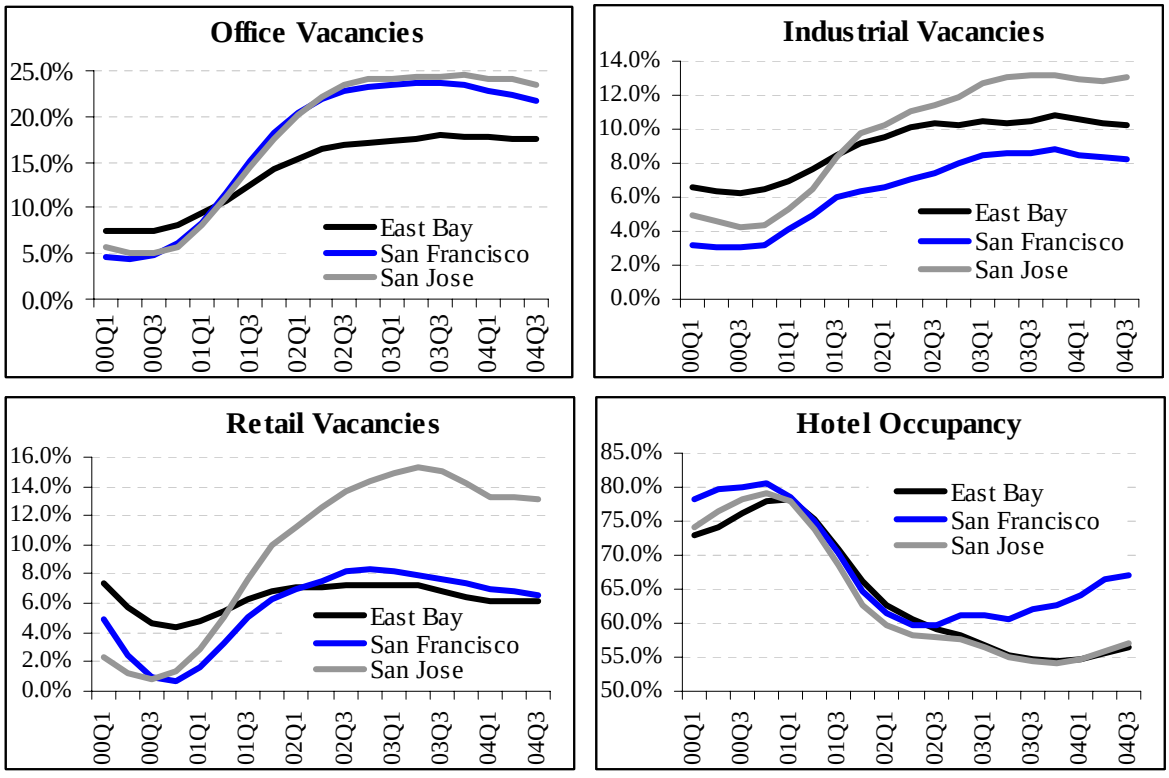
Of course all these numbers are preliminary and next month will see the release of the updated employment numbers for the state and regions. Last year's revisions were not kind to the East Bay, showing an economy that had shrunk at a far more substantial pace than initially thought. Yet this year, if anything, the numbers are more likely to be better than worse, at least as far as can be interpreted from the quarterly figures that come from a broader sample of employers. These numbers are substantially lagged hence are not used for current month statistics, but they do form the basis of the revisions that occur on an annual basis. Given these numbers we expect to see a large revision upward in employment figures for Orange County and Sacramento, while small to moderate upward revisions are likely to occur in the East Bay, San Jose, and the Inland Empire. Small downward revisions or no revisions at all are expected in Los Angles and San Francisco.

'But WAIT!' you may be saying, 'You can't POSSIBLY be saying that the regulatory tangle the state has created and the clearly extensive costs of doing business here are not having an impact on the economy.' You are right. I am not saying this. Business costs do have an impact, but not in the way you might think. If costs alone determined where a business formed, there would be no place called Manhattan or even a

financial district in San Francisco. It's clear that the choice of location has to do more with the location of buyers, the location of supplies, access to transportation, and access to a qualified workforce. Instead, in a competitive environment the cost of doing business gets passed on to consumers in the form of higher product prices and to workers in the form of lower wages. Higher prices and lower wages will slow long run growth but will have limited impact on an economy in the short run.

So summing up, the cost of doing business has a large impact on the economy, but not so much through growth as much as through the quality of life we enjoy. The high price of housing is due in part to the burden that developers face trying to build new residences. The size of the uninsured population is due in part to the high cost of healthcare in a state that has tried to regulate this sector from top to bottom as opposed to allowing competition to find the most efficient form of operation. If we want to make California a better place to live, we need to start by making it friendlier for businesses -- not to benefit the businesses but to benefit ourselves. And in the long run the best solution is education, because the costs of employing workers are proportionally lower for higher skilled, higher paid workers than for the low skilled.

An Update on the Non-Residential Sector



Data courtesy of PPR Consulting

The residential real estate bubble in California has dominated much of the discussion over the past year, I am going to use this first report of 2005 to consider the non-residential sector which represents much of what has happened in the Bay area. This sector reflects much of the boomtown mentality that swept the region in the late nineties. New firms could not get enough space to fill their (or their venture capitalist financers') needs, and vacancy rates began to drop in every major sector even as rents almost doubled. As a result, massive amounts of new construction were being pushed into the pipeline. Of course many of these were still in the pipeline when the bubble popped and the region began to lose jobs at a record pace. San Francisco and San Jose both saw office vacancies rise from below 5% to close to a quarter of all available space. The comparatively stable East Bay only saw vacancies rise to 18%. In San Francisco and San Jose about half of the increase in vacancy rates over the past three years has been due to new supply coming on the market after the crash, while the other half reflects declining occupancy. In the East Bay almost all the increase was due to increases in supply with occupied space falling very little. Rents, of course, collapsed.

Industrial vacancies showed a similar pattern but a smaller rise overall. The East Bay saw vacancy rates rise from 6% to 11%, while San Francisco saw an increase from 3% to 8.5%. Here most of the change was due to new supply coming online with little real declines in occupied space. Retail space in the Bay Area—nationwide the only solid non-residential property type—also took a hit and saw rising vacancy rates, from 4% to 7% in the East Bay and from 1% to 8% in San Francisco. For the East Bay most of this was again a result of new space becoming available. Indeed even though occupancy rates are lower now, there is more square footage of retail space rented than there was in 2000. San Jose has been hit worse than either of its two neighbors. Industrial space vacancies increased from 4% to 13%, and empty retail space rose from 1% to 16%. This has been a combination of both supply and demand.

As with employment, the first signs of turnaround have been seen in the non-residential market. Although the signs are still quite tentative, they are there. Net absorption in any of these markets has been

Current Office Occupancy and Rents: Bay Area

	Office		Industrial		Retail		Non-Res Inv.	
	Occ. SF	Rent	Occ. SF	Rent	Occ. SF	Rent	04 (m)	ch
East Bay	71,300	$26.7	101,900	$5.5	89,800	$23.9	$1,035	1.5%
San Francisco	79,900	$27.8	31,800	$7.5	65,800	$25.7	$899	26.9%
San Jose	57,600	$27.6	37,500	$6.8	51,300	$23.9	$848	-12.8%
US Average		*$27.2*		*$5.3*		*$18.2*		

Occupied space data in 1000's of square feet. Rent data price per square foot per year. Courtesy NREI.

soft, but still positive and for the first time rents have actually started to rise in San Francisco, although they continue to soften in the East Bay and San Jose. While rental prices have essentially halved over the past three years, this is from an incredible high. Rates in the Bay still remain slightly above the national averages—more expensive than most of the country but affordable relative to the Northeast. The business driven hotel markets in San Jose and the East Bay have seen an increase in occupancy rates over the last two quarters, lagging behind the tourism driven market in San Francisco that began recovery as early as 2002.

The net result is that it is still a buyers' market for non-residential space in the Bay Area. And although the market has shown some signs of stabilization it will remain a buyers' market for some time yet. Employment growth will be okay over the next year, but not enough to make a serious dent in much of the over-capacity built into the system. Look for rental prices to stay flat. As for building, the East Bay remains the only place with any real activity on the non-residential front, with most new permits going for new retail construction needed to support the many new residences being built in the area. As with construction jobs, look for this boom to end over the next 18 months. San Francisco saw some increase in spending on new non-residential projects but the amount permitted in 2004 was less than a third of 2000's levels, and much of it was for secondary work on existing structures. San Jose saw fewer new permits in 2004 than 2003 and a rate approximately a fourth of what it was four years ago. Indeed the one lingering hangover in the Bay Area economy for the next few years will be over-capacity in its non-residential markets. Los Angeles saw a similar bust and 15 years later the downtown area is still saddled with this problem. Don't look for any new skyscrapers to adorn the Bay Area skylines anytime soon.